ST 97-21
Tax Type: SALES TAX
Issue: Organizational Exemption From Use Tax (Charitable)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

TAXPAYER	)	
	)	
	)	**DOCKET:**
Applicants,	)	
	)	
v.	)	**Sales Tax Exemption**
	)	**Denial**
	)	
THE DEPARTMENT OF REVENUE,	)	**Alan I. Marcus,**
STATE OF ILLINOIS	)	**Administrative Law Judge**
	)	

RECOMMENDATION FOR DISPOSITION

APPEARANCES: Mr. Alan E. Sohn appeared on behalf of TAXPAYER; Mr. Mark E. Dyckman, Special Assistant Attorney General, appeared on behalf of the Department of Revenue; Mr. Paul Bogdanski, appeared on behalf of the Office of Attorney General Jim Ryan.

SYNOPSIS:

These proceedings raise two issues. The first is whether any or all of the above-mentioned corporations qualify for exemption from payment of Use[1] and related taxes pursuant to 35 **ILCS** 105/3-5(4). In relevant part, that provision states as follows:

> Use of the following tangible personal property is exempt from the tax imposed by this Act:
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> (4) Personal property purchased by ... a corporation, society, association, foundation,

1. Imposition of that tax and all issues related thereto are governed by the Use Tax Act, 35 **ILCS** 105/1 *et seq*.

> or institution organized exclusively for ... educational purposes ... [.]

The second issue assumes that these corporations qualify for the aforementioned exemptions and involves whether TAXPAYER and TAXPAYER were denied due process because the Department of Revenue, (hereinafter the "Department") revoked their exemption numbers via a letter dated October 8, 1996.

The controversies arise as follows:

On August 30, 1996, TAXPAYER (hereinafter "RNGI"), through counsel, filed a written request with the Department to be exempt from payment of Use and related taxes pursuant to 35 **ILCS** 105/3-5(4). The Department denied RNGI's request via correspondence dated October 31, 1996 and also indicated that it was summarily revoking the exemptions it had previously granted to three related entities, TAXPAYER (hereinafter "RGHI"), TAXPAYER (hereinafter "RCCI") and TAXPAYER (hereinafter "RCCM").[2]

On October 11, 1996, applicants' counsel filed a request for hearing with the Department. Applicants subsequently filed a motion for voluntary dismissal without prejudice with the Department. On January 8, 1997, I issued an Order denying this motion, whereupon applicants proceeded with the requested hearing. During this hearing, applicant moved for, and was granted, withdrawal as to RCCM. (Tr. pp. 37-38). It did however, present evidence as to the remaining applicants. Following submission of that evidence and a

[2].In the interest of avoiding redundancy and unnecessary confusion, I shall refer to RNGI, RGHI, RCCI and RCCM as the "applicants" except where it becomes necessary to identify the entities by their individual names.

careful review of the record, it is recommended that the Department's tentative denial of exemption as to RNGI be finalized as issued. It is further recommended that the revocations of exemption which pertain to RGHI and RCCI be affirmed and finalized as issued.

FINDINGS OF FACT:

1. The Department's *prima facie* case, inclusive of all jurisdictional elements, is established by the admission into evidence of the Department's Tentative Denial of Exemption, (Dept. Ex. No. 1), wherein RNGI's request for exempt status was denied and the then-existing exemption numbers issued to RGHI and RCCI were revoked.

2. The applicants are for-profit corporations, all are incorporated under the Business Corporation Act of Illinois. Applicant Ex. Nos. 1A and 2A; Applicant Ex. No. 3; Tr. p. 115.

2. RGHI was incorporated on June 14, 1985. Its stated purposes are to operate "exclusively for educational purposes and provide systematic instruction in useful branches of learning by methods common to public schools and which compare favorably in their scope and intensity with the course of study presented in tax supported schools." Applicant Ex. No. 1A; Tr. pp. 46-47.

3. Financial statements disclose that RGHI's total income for the year ending December 31, 1995 was $1,052,399.02. RGHI derived 39.3% of this total from private pay fees. It also derived the vast majority of its other income from the following fee sources: 17.6% from the Illinois Department of Children and Family Services (hereinafter "DCFS"); 8.7% from public aid - chance; 8.9% from public aid - transitional; .2% from J.T.P.A. [unexplained source]; 20.3%

from public aid; and 2.5% from an unspecified food bank. Applicant Ex. No. 1A; Tr. p. 67.

4. The same financial statements disclose that RGHI incurred $982,643.59 in total expenses for the year ending December 31, 1995. Said expenses were apportioned as follows: 54.8% to program expenses; 11.8% to consumable expenses; 15.4% to occupancy expenses and 11.3% to administrative expenses. *Id*.

5. RCCI was incorporated on October 12, 1990. Its stated purposes are the same as RGHI. Applicant Ex. No. 2A; Tr. p. 48.

6. Financial statements disclose that RCCI'S total income for the year ending December 31, 1995 was $1,472,748.34. RCCI derived 54.2% of this total from private pay fees. It also derived the vast majority of its other income from the following fee sources: 4.1% from DCFS; 5.5% from public aid - chance; 5.4% from public aid - transitional; 4.8% from direct payments from public aid; .4% Pekin Hospital; and .6% from an unspecified food bank. Applicant Ex. No. 2A; Tr. p. 68.

7. The same financial statements disclose that RCCI incurred $1,442,997.74 in total expenses for the year ending December 31, 1995. Said expenses were apportioned as follows: 40.5% to program expenses; 12.2% to consumable expenses; 9.3% to occupancy expenses and 36.1% to administrative expenses. *Id*.

8. RNGI was incorporated on December 20, 1993. Its stated purposes are the same as RGHI and RCCI except that RNGI is also authorized to "solely and exclusively provide physical facilities so as to carry out the aforesaid exclusive educational purpose: to purchase, hold, sell, improve and lease real estate and mortgage and

encumber the same and to erect, care for and maintain, extend, alter and improve buildings thereon, and purchase, lease, and maintain the equipment thereon." [sic]. Applicant Group Ex. No. 3; Tr. p. 69.

9. Financial statements disclose that RNGI's total income for the year ending December 31, 1995 was $407,873.14. RNGI derived 41.2% of this total from private pay fees. It also derived the vast majority of its other income from the following fee sources: 6.9% from DCFS; 9.1% from public aid - chance; 8.3% from public aid - transitional; 1.4% from J.T.P.A. and 24.6% from direct payments from public aid. *Id*.

10. The same financial statements disclose that RNGI incurred $407,781.65 in total expenses for the year ending December 31, 1995. Said expenses were apportioned as follows: 49.7% to program expenses; 15.8% to consumable expenses; 24.4% to occupancy expenses and 10.2% to administrative expenses. *Id*.

12. RNGI and the other applicants apply all excess revenues to internal operations, such as raising salaries and renovating the buildings. Tr. p. 114.

13. DCFS issued RNGI a license to operate a full-time day care facility on July 16, 1995. The license will expire July 16, 1998. Applicant Group Ex. No. 3A; Tr. pp. 55 - 56.

14. Applicants' programs center around what RCCI refers to as a "multi-conceptual, educational, pre-primary curriculum for infants through pre-kindergarten." [sic]. These programs feature interactive instruction, thematics and other child-initiated activities. Applicant Ex. No. 4.

15. The nursery program for infants consists of the following daily routine: greeting time, a morning feeding, a morning diapering, a morning nap, educational playtime, lunch feeding, noon diapering, an afternoon nap, an afternoon snack and afternoon playtime. Specific activities include games designed to foster cognitive and social skills, such as hide and go seek, follow the leader and peek a boo. Other aspects of the program involve audio [hearing-related] exercises, physical activities, such as having infants follow objects with their eyes or grasp objects, and language exercises including name recognition and descriptive dialogue. *Id*.

16. The toddler through pre-kindergarten program is directed to children between the ages of two and four. Their classrooms feature a large calendar, a weather display and an area that is interchangeably used to teach art and writing or other language-related skills. *Id*.

17. The classrooms also include a quiet area, where age-appropriate books and puzzles are kept, and areas devoted to music, games that promote motor skills, blocks, and housekeeping. *Id*.

18. The daily schedule for the toddler through pre-kindergarten program begins with greeting time. It then progresses to breakfast, circle time, (or that portion of the day devoted to direct instruction), small activity time (wherein no more than 10 children are assigned to an adult), large activity time (wherein the adult plans activities for larger groups such as music, creative movement, and dramatic play), lunch time (which includes a nap) and an afternoon snack. The day then concludes with an afternoon schedule consisting of various activities (e.g. classroom

maintenance, games, interest-area play, etc.) in half-hour segments. *Id*.

17. Specific activities conducted in the toddler through pre-kindergarten program include coloring exercises and thoughtful play. *Id*.

19. Thoughtful play involves three stages of interaction with the children: first, planning or that period of time wherein the children choose a specific interest area for their play; second, the actual playing time itself; and third, remembering or having the children relate what took place during the play session to the entire class. *Id*.

CONCLUSIONS OF LAW:

On examination of the record established this taxpayer has not demonstrated, by the presentation of testimony or through exhibits or argument, evidence sufficient to overcome the Department's *prima facie* case. Accordingly, under the reasoning given below, that portion of the *prima facie* case which consists of the Department's determination that RNGI does not qualify for exemption from Use and related taxes as a "corporation, society, association, foundation or institution organized and operated exclusively for educational ... purposes" within the meaning of 35 **ILCS** 105/3-5(4) should be affirmed. Furthermore, those remaining portions of the *prima facie* case which revoked the exemptions previously granted to RCCI and RGHI should likewise be affirmed. In support thereof, I make the following conclusions:

Applicants herein claim that they are entitled to exemption from Use and related sales taxes under 35 **ILCS** 105/3-5(4). In relevant part, that provision states as follows:

> Exemptions. Use of the following tangible personal property is exempt from the [Use] tax imposed by this Act:
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> ***
>
> (4) Personal property purchased by a government body, by a corporation, society, association, foundation, or institution organized and operated exclusively for ... educational purposes ...[.]

It is well established in Illinois that a statute exempting property or an entity from taxation must be strictly construed against exemption, with all facts construed and debatable questions resolved in favor of taxation. People Ex Rel. Nordland v. Home for the Aged, 40 Ill.2d 91 (1968); Gas Research Institute v. Department of Revenue, 154 Ill. App.3d 430 (1st Dist. 1987), (hereinafter "GRI"). Based on these rules of construction, Illinois courts have placed the burden of proof on the party seeking exemption and have required such party to prove by clear and convincing evidence that it falls within the appropriate statutory exemption. Metropolitan Sanitary District of Greater Chicago v. Rosewell, 133 Ill. App.3d 153 (1st Dist. 1985).

Illinois courts have not addressed the precise threshold issue raised by these applicants, which is whether a series of for-profit corporations, all of which offer early infant and early childhood-development programs, constitute "corporation[s], societ[ies], association[s], foundation[s], or institution[s] organized and operated exclusively for ... educational purposes ..." within the

meaning of 35 **ILCS** 105/3-5(4). Nevertheless, in Yale Club of Chicago v. Department of Revenue, 214 Ill. App.3d 468 (1st Dist. 1991) (hereinafter "Yale"), the court analyzed appellant's claims for educational and charitable exemptions under the Retailer's Occupation Tax Act according to the body of case law developed for analysis of property tax exemptions. While the court's analysis of the charitable exemption has limited relevance to disposition of the present case, its reliance on Illinois College of Optometry v. Lorenz, 21 Ill. 219 (1961), (hereinafter "ICO")[3] provides the basic framework for analyzing applicants' exemption claims.

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3. *See also*, Coyne Electrical School v. Paschen, 12 Ill.2d 387 (1957); Board of Certified Safety Professionals of the Americas v. Johnson, 112 Ill. 2d 542 (1986); American College of Chest Physicians v. Department of Revenue, 202 Ill. App.3d. 59 (1st Dist. 1990); Winona School of Professional Photography v. Department of Revenue, 211 Ill. App.3d 565 (1st Dist. 1991).

4. Illinois courts have long adhered to the following definition of "school," originally set forth in People ex rel. McCullough v. Deutsche Evangelisch Lutherisch Jehova Gemeinde Ungeanderter Augsburgischer Confession, 249 Ill. 132 (1911), (hereinafter "McCullough"), when analyzing claims for educational exemptions:

> A school, within the meaning of the Constitutional provision, is a place where systematic instruction in useful branches is given by methods common to schools and institutions of learning, which would make the place a school in the common acceptation [sic] of the word.

This definition is certainly relevant to the present case. However, I believe that the first prong of the ICO test incorporates most, if not all, of the above-stated standards. Furthermore, cases decided after ICO seem to have placed greater emphasis on the two part test articulated therein than the formal definition set forth in McCullough. (*See*, Yale, *supra* at 474). Accordingly, I conclude that the test articulated in ICO presents the modern, and therefore most relevant, criteria for analyzing the present facts.

In ICO, the court held that private organizations, such as applicants, cannot be classified as "school[s]"[4] and therefore claim exemption from taxes unless they prove both of the following propositions by clear and convincing evidence: First, that applicants offer a course of study which fits into the general scheme of education established by the State; and second, that applicants substantially lessen the tax burdens by providing educational training that would otherwise have to be furnished by the State.

The instant record contains numerous evidentiary deficiencies which establish that applicants have failed to prove their compliance with either prong of the test enunciated in ICO. First, applicants' curriculum coordinator, WITNESS, did not testify even though she is responsible for preparing applicants' curriculum. (Tr. pp. 36, 58). Applicants' secretary/treasurer, TAXPAYER, who did testify, admitted that he had no expertise in the area of applicants' curriculum. (Tr. pp. 69 - 70). Based upon this admission, and the absence of WITNESS's testimony, I find that applicants did not present any competent witnesses to establish that they offer "a course of study which fits into the general scheme of education established by the State" as required by ICO.

Applicants seek to overcome this failure of proof through the testimony of PROFESSOR, whose credentials include an assistant professorship in education at National Lewis University, a chairpersonship of the Early Childhood Department at the National College of Education, a Masters' of Education in Early Childhood Leadership from the University of Illinois at Chicago and work toward

a doctoral degree in Educational Psychology at National Lewis University.[5] While these credentials qualify PROFESSOR as an expert in the area of early childhood education,[6] I do not find her opinions persuasive for a number of reasons.

First, her opinions that applicants' programs are "departmentally appropriate" and "educationally sound" (Tr. p. 98) are conclusory and do not satisfy the standards set forth in ICO. In addition, her opinion that applicants' programs are consistent with the standards established by the National Academy of Early Childhood Programs (hereinafter the "Academy") falls short of establishing conformity with ICO because the Academy is a private (rather than State-sponsored) organization created by professionals in the field of early childhood education. (Tr. pp. 100, 110). For these reasons, and because applicant offered no evidence to establish that the State of Illinois currently requires early childhood education centers to be accredited by the Academy or even accepts Academy standards, I conclude that PROFESSOR' testimony fails to establish applicants' compliance with the "course of study" requirement established in ICO.

PROFESSOR' testimony also lacks persuasive effect for other reasons. First, she visited only one of the three facilities which applicants currently seek to exempt. (Tr. pp. 105 - 106)

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[5]. A complete recitation of PROFESSOR qualifications can be found in Applicant Ex. No. 9 and at Tr. pp. 71 - 90.

[6]. Analysis of the legal requirements for establishing the qualifications and competency of experts giving opinion testimony can be found in Taylor v. The Carborundum Co, 107 Ill. App.2d 12 (1st Dist. 1969); People v. Johnson, 145 Ill. App.3d 626 (1st Dist. 1986).

Furthermore, PROFESSOR could not remember which one of the three facilities she visited. (*Id*.).

The aforementioned rules of construction require that *each* of the three applicants prove its right to exemption by clear and convincing evidence. Therefore, I do not find the above weaknesses in PROFESSOR' testimony to be credibly explained by her conversations with applicants' curriculum director, whom I re-emphasize did not testify. (Tr. pp. 111 - 112). Based on this finding, and all of the above analysis, I conclude that applicants' evidence falls short of the clear and convincing standard necessary to establish conformity with the first prong of ICO.

Analysis of the second prong, which requires applicants to prove that they substantially lessen the tax burdens by providing educational training that would otherwise have to be furnished by the State, begins with recognition of some fundamental economic and legal principles. First, all tax exemptions intrinsically increase the State's financial burden by imposing lost revenue costs on the State treasury. Accordingly, such exemptions must be denied absent appropriate evidence that applicants' services ease the State's financial burden by conferring benefits on the general public which, at minimum, offset any lost revenue costs. ICO, *supra* at 221, Yale, *supra* at 474; *See also*, People ex. rel. Brenza v. Turnverein Lincolon, 8 Ill.2d 188, 202-203 (1956); DuPage County Board of Review v. Joint Commission on Accreditation of Healthcare Organizations, 274 Ill. App.3d 461 (2nd Dist. 1995).

Second, that the word "exclusively," when used in Section 105/3-5(4) and other tax exemption statutes means "the primary purpose for

which property is used and not any secondary or incidental purpose." GRI, *supra*; Pontiac Lodge No. 294, A.F. and A.M. v. Department of Revenue, 243 Ill. App.3d 186 (4th Dist. 1993). "Statements of the agents of an institution and the wording of its governing documents evidencing an intention to [engage in exclusi0vely charitable activity] do not relieve such an institution of the burden of proving that ... [it] actually and factually [engages in such activity]." Morton Temple Association v. Department of Revenue, 158 Ill. App. 3d 794, 796 (3rd Dist. 1987). Therefore, it is necessary to analyze the activities of the applicants in order to determine whether they are as educational organizations as they purport to be in their charters. *Id*.

Each of the three applicants herein is a for-profit corporation. Such corporations are, by their very nature, designed to confer pecuniary benefits on their shareholders rather than the general public. Thus, they inherently violate the "public benefit" aspect of tax exemption which Illinois courts have long recognized as being fundamental to this particular body of law. Yale, *supra* at 474.

In addition, the for-profit structure of applicants' enterprise negates any inference that applicants ease the State's financial burden by providing services to children whose fees are paid from public sources, such as DCFS. The above-stated principles imply that this inference can be made only where applicants prove that each corporation operates for the primary purpose of conferring benefits on the general public. However, for-profit corporations, such as applicants, are inherently designed to confer pecuniary benefits primarily on their non-exempt shareholders. Therefore, any

incidental public benefits would be legally insufficient to sustain applicants' burden of proof. *Cf.*, GRI, *supra*.

The above inference also is also negated by the necessity for avoiding a situation wherein any corporation could achieve exempt status merely by obtaining funding from, or performing services for, the State of Illinois or other public entities. Such a scenario is inconsistent with applicable law because it effectively relieves those applying for exempt status of their respective burdens of proving that they substantially reduce tax burdens as required by ICO.

In order to avoid this scenario in the present case, I note that the record is devoid of evidence establishing that tax savings attributable to applicants' services, if any, are passed on to the general public. Rather, the above analysis has demonstrated that such savings intrinsically inure to the exclusive benefit of applicant's non-exempt shareholders. Consequently, applicants have failed to prove that the costs associated with granting their requests for exempt status outweigh any benefits to Illinois taxpayers. Therefore, I conclude that the tax-savings criteria articulated in ICO and considerations of sound public policy require that these applicants carry on their work without the benefit of exempt status.

In light of the above conclusion, I find it unnecessary to engage in protracted analysis of the due process issue. The preceding analysis has demonstrated that the exemptions for RGHI and RCCI were issued in error, and therefore, void *ab initio*. As such, any possible procedural violations are cured by these hearings

wherein applicants have had full opportunity to present their evidence regarding their claims to entitlement to tax exemptions.

WHEREFORE, for all the above-stated reasons, it is my recommendation that the Department's decision revoking the exemptions previously granted to RGHI and RCCI, and denying RNGI exemption from use and related taxes pursuant to Section 105/3-5(4), be affirmed.

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Date Alan I. Marcus,
Administrative Law Judge